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The Truth About the "Robber Barons"

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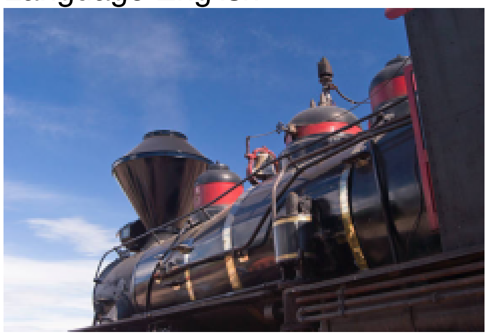

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[[2]This article is excerpted from chapter 7 of *How Capitalism Saved America* [3].]

> Free-market capitalism is a network of free and voluntary exchanges in which producers work, produce, and exchange their products for the products of others through prices voluntarily arrived at. State capitalism consists of one or more groups making use of the coercive apparatus of the government… for themselves by expropriating the production of others by force and violence.
>
> — Murray N. Rothbard, *The Logic of Action* (1997)

The late nineteenth and early twentieth centuries are often referred to as the time of the "robber barons."

It is a staple of history books to attach this derogatory phrase to such figures as John D. Rockefeller, Cornelius Vanderbilt, and the great nineteenth-century railroad operators — Grenville Dodge, Leland Stanford, Henry Villard, James J. Hill, and others. To most historians writing on this period, these entrepreneurs committed thinly veiled acts of larceny to enrich themselves at the expense of their customers. Once again we see the image of the greedy, exploitative capitalist, but in many cases this is a distortion of the truth.

As common as it is to speak of "robber barons," most who use that term are confused about the role of capitalism in the American economy and fail to make an important distinction — the distinction between what might be called a market entrepreneur and a political entrepreneur. A pure *market entrepreneur,* or capitalist, succeeds financially by selling a newer, better, or less expensive product on the free market without any government subsidies, direct or indirect. The key to his success as a capitalist is his ability to please the consumer, for in a capitalist society the consumer ultimately calls the economic shots. By contrast, a *political entrepreneur* succeeds primarily by influencing government to subsidize his business or industry, or to enact legislation or regulation that harms his competitors.

In the mousetrap industry, for instance, you can be a market entrepreneur by making better mousetraps and thereby convincing consumers to buy more of your mousetraps and less of your competitors', or you can lobby Congress to prohibit the importation of all foreign-made mousetraps. In the former situation the consumer voluntarily hands over his money for the superior mousetrap; in the latter case the consumer, not given anything (better) in return, pays more for existing mousetraps just because the import quota has reduced supply and therefore driven up prices.

The American economy has always included a mix of market and political entrepreneurs — self-made men and women as well as political connivers and manipulators. And sometimes, people who have achieved success as market entrepreneurs in one period of their lives later become political entrepreneurs. But the distinction between the two is critical to make, for market entrepreneurship is a hallmark of genuine capitalism, whereas political entrepreneurship is not — it is neomercantilism.

In some cases, of course, the entrepreneurs commonly labeled "robber barons" did indeed profit by exploiting American customers, but these were *not market* entrepreneurs. For example, Leland Stanford, a former governor and US senator from California, used his political connections to have the state pass laws prohibiting competition for his Central Pacific railroad,[1] and he and his business partners profited from this monopoly scheme. Unfortunately, the resentment that this naturally generated among the public was unfairly directed at other entrepreneurs who succeeded in the railroad industry without political interference that tilted the playing field in their direction. Thanks to historians who fail to (or refuse to) make this crucial distinction, many Americans have an inaccurate view of American capitalism.

How to Build a Railroad

Most business historians have assumed that the transcontinental railroads would never have been built without government subsidies. The free market would have failed to provide the adequate capital, or so the theory asserts. The evidence for this theory is that the Union Pacific and Central Pacific railroads, which were completed in the years after the War Between the States, received per-mile subsidies from the federal government in the form of low-interest loans as well as massive land grants. But there need not be cause and effect here: the subsidies were not needed to *cause* the transcontinental railroads to be built. We know this because, just as many roads and canals were privately financed in the early nineteenth century, a market entrepreneur built his own transcontinental railroad. James J. Hill built the Great Northern Railroad "without any government aid, even the right of way, through hundreds of miles of public lands, being paid for in cash," as Hill himself stated.[2]

Quite naturally, Hill strongly opposed government favors to his competitors: "The government should not furnish capital to these companies, in addition to their enormous land subsidies, to enable them to conduct their business in competition with enterprises that have received no aid from the public treasury," he wrote.[3] This may sound quaint by today's standards, but it was still a hotly debated issue in the late nineteenth century.

James J. Hill was hardly a "baron" or aristocrat. His father died when he was fourteen, so he dropped out of school to work in a grocery store for four dollars a month to help support his widowed mother. As a young adult he worked in the farming, shipping, steamship, fur-trading, and railroad industries. He learned the ways of business in these settings, saved his money, and eventually became an investor and manager of his own enterprises.[4] (It was much easier to accomplish such things in the days before income taxation.)

Hill got his start in the railroad business when he and several partners purchased a bankrupted Minnesota railroad that had been run into the ground by the government-subsidized Northern Pacific (NP). The NP had been a patronage "reward" to financier Jay Cooke, who in the War Between the States had been one of the Union's leading financiers.[5] But Cooke and his NP associates built

recklessly; the government's subsidies and land grants were issued on a per-mile-of-track basis, so Cooke and his cohorts had strong incentives to build as quickly as possible, which only encouraged shoddy work. Consequently, by 1873 the NP developers had fallen into bankruptcy.[6] The people of Minnesota and the Dakotas, where the railroad was being built, considered Cooke and his business associates to be "derelicts at best and thieves at worst," writes Hill biographer Michael P. Malone.[7]

It took Hill and his business partners five years to complete the purchase of the railroad (the St. Paul, Minneapolis, and Manitoba), which would form the nucleus of a road that he would eventually build all the way to the Pacific (the Great Northern). He had nothing but contempt for Cooke and the NP for their shady practices and corruption, and he quickly demonstrated a genius for railroad construction. Under his direction, the workers began laying rails twice as quickly as the NP crews had, and even at that speed he built what everyone at the time considered to be the highest-quality line. Hill micromanaged every aspect of the work, even going so far as to spell workers so they could take much-needed coffee breaks.[8] His efficiency extended into meticulous cost cutting. He passed his cost reductions on to his customers in the form of lower rates because he knew that the farmers, miners, timber interests, and others who used his rail services would succeed or fail along with him. His motto was: "We have got to prosper with you or we have got to be poor with you."[9]

In keeping with his philosophy of encouraging the prosperity of the people residing in the vicinity of his railroad, Hill publicized his views on the importance of crop diversification to the farmers of the region. He didn't want them to become dependent on a single crop and therefore subject to the uncertainties of price fluctuation, as the southern cotton farmers were.[10] Hill also provided free seed grain — and even cattle — to farmers who had suffered from drought and depression; stockpiled wood and other fuel near his train depots so farmers could stock up when returning from a delivery to his trains; and donated land to towns for parks, schools, and churches.[11] He transported immigrants to the Great Plains for a mere ten dollars if they promised to farm near his railroad, and he sponsored contests for the beefiest livestock or the most abundant wheat. His "model farms" educated farmers on the latest developments in agricultural science. All of this generated goodwill with the local communities and was also good for business.

Hill's rates fell steadily, and when farmers began complaining about the lack of grain storage space, he instructed his company managers to build larger storage facilities near his rail depots. He refused to join in attempts at cartel price fixing and in fact "gloried in the role of rate-slasher and disrupter of [price-fixing] pooling agreements," writes historian Burton Folsom.[12] After all, he knew that monopolistic pricing would have been an act of killing the goose that lays the golden egg.

In building his transcontinental railroad, from 1886 to 1893, Hill applied the same strategy that he had in building the St. Paul, Minneapolis, and Manitoba: careful building of the road combined with the economic cultivation of the nearby communities. He always built for durability and efficiency, not scenery, as was sometimes the case with the government-subsidized railroads. He did not skimp on building materials, having witnessed what harsh Midwest winters could do to his facilities and how foolish it was for the NP to have ignored this lesson. (The solid granite arch bridge that Hill built across the Mississippi River was a Minneapolis landmark for many years.)[13] Burton Folsom describes Hill's compulsion for excellence:

> Hill's quest for short routes, low grades, and few curvatures was an obsession. In 1889, Hill conquered the Rocky Mountains by finding the legendary Marias Pass. Lewis and Clark had described a low pass through the Rockies back in 1805; but later no one seemed to know whether it really existed or, if it did, where it was. Hill wanted the best gradient so much that he hired a man to spend months searching western Montana for this legendary pass. He did in fact find it, and the ecstatic Hill shortened his route by almost one hundred miles.[14]

Hill's Great Northern was, consequently, the "best constructed and most profitable of all the world's major railroads," as Michael P. Malone points out.[15] The Great Northern's efficiency and profitability

were legendary, whereas the government-subsidized railroads, managed by a group of political entrepreneurs who focused more on acquiring subsidies than on building sound railroads, were inefficiently built and operated. Jay Cooke was not the only one whose government-subsidized railroad ended up in bankruptcy. In fact, Hill's Great Northern was the only transcontinental railroad that never went bankrupt.

James J. Hill versus the *Real* Robber Barons

By the summer of 1861, after the Battle of First Manassas, it was apparent to all that the War Between the States was going to be a long drawn-out campaign. Nevertheless, in 1862 Congress, with the southern Democrats gone, diverted millions of dollars from the war effort to begin building a subsidized railroad. The Pacific Railroad Act of 1862 created the Union Pacific (UP) and the Central Pacific (CP) railroads, the latter to commence building in Sacramento, California, and the former in Omaha, Nebraska. For each mile of track built Congress gave these companies a section of land — most of which would be sold — as well as a sizable loan: $16,000 per mile for track built on flat prairie land; $32,000 for hilly terrain; and $48,000 in the mountains.[16] As was the case with Jay Cooke's Northern Pacific, these railroads tried to build as quickly and as cheaply as possible in order to take advantage of the governmental largesse.

Where James J. Hill would be obsessed with finding the shortest route for his railroad, these government-subsidized companies, knowing they were paid by the mile, "sometimes built winding, circuitous roads to collect for more mileage," as Burton Folsom recounts.[17] Union Pacific vice president and general manager Thomas Durant "stressed speed, not workmanship," writes Folsom, which meant that he and his chief engineer, former Union Army genera1 Grenville Dodge, often used whatever kind of wood was available for railroad ties, including fragile cottonwood. This, of course, is in stark contrast to James J. Hill's insistence on using only the best-quality materials, even if they were more expensive. Durant paid so many lumberjacks to cut trees for rails that farmers were forced to use rifles to defend their land from the subsidized railroad builders; not for him was the Hill motto, "We have got to prosper with you or we have got to be poor with you." Folsom continues:

> Since Dodge was in a hurry, he laid track on the ice and snow…. Naturally, the line had to be rebuilt in the spring. What was worse, unanticipated spring flooding along the lower fork of the Platte River washed out rails, bridges, and telephone poles, doing at least $50,000 damage the first year. No wonder some observers estimated the actual building cost at almost three times what it should have been.[18]

In 1869, after seven years of construction, the two subsidized railroads managed to meet up at Promontory Point, Utah, amidst much hoopla and celebration. What is not often mentioned, however, is that after the big celebration both of the lines had to be rebuilt and even relocated in places, a task that took five more years (into 1874).

The wasteful costs of construction were astonishing. The subsidized railroads routinely used more gunpowder blasting their way through mountains and forests on a single day than was used during the entire Battle of Gettysburg.

With so much tax money floating around, the executives of the CP and UP stole funds from their own companies in order to profit personally, something that would have been irrational for James J. Hill or any other private, market entrepreneur to do. For example, the UP managers created their own coal company, mining coal for two dollars per ton and selling it to themselves for six dollars per ton, pocketing the profits. This crooked scam was repeated in dozens of instances and would be exposed as the Crédit Mobilier scandal. (Crédit Mobilier was the name of one of the companies run by UP executives.)

With virtually everything riding on political connections, as opposed to creating the best-quality railroad for consumers, the UP and CP executives naturally spent an inordinate amount of time on politics as opposed to business management. While James J. Hill detested politicians and politics and paid little attention to them, things were very different with the UP. Folsom explains:

> In 1866 Thomas Durant wined and dined "prominent citizens" (including senators, an ambassador, and government bureaucrats) along a completed section of the railroad. He hired an orchestra, a caterer, six cooks, a magician (to pull subsidies out of a hat?), and a photographer. For those with ecumenical palates, he served Chinese duck and Roman goose; the more adventurous were offered roast ox and antelope. All could have expensive wine and, for dessert, strawberries, peaches, and cherries. After dinner some of the men hunted buffalo from their coaches. Durant hoped that all would go back to Washington inclined to repay the UP for its hospitality.[19]

In addition, free railroad passes and Crédit Mobilier stock were routinely handed out to members of Congress and state legislators, and General William Tecumseh Sherman was sold land near Omaha, Nebraska, for $2.50 an acre when the going rate was $8.00.

Congress responded to the 1874 Crédit Mobilier scandal by enacting a blizzard of regulations on the UP and CP that would in the future make it impossible for them to operate with any semblance of efficiency. Because of the regulations, managers could not make quick decisions regarding leasing, borrowing money, building extensions of the rail lines, or any other day-to-day business decision. Each such decision literally required an act of Congress.

Political interference also meant that separate rail lines were required to be built to serve communities represented by influential members of Congress even if those lines were uneconomical. No business could possibly survive and earn a profit under such a scenario. The UP went bankrupt in 1893; the Great Northern, on the other hand, was still going strong. Not having accepted any government subsidies, James J. Hill was free to build and operate his railroad in a way that he deemed was most efficient and most profitable. He prospered while most of his subsidized competitors went bankrupt at one point or another.

Hill continued to show how effective market entrepreneurs could be. Having completed the Great Northern, he then got into the steamship business in order to facilitate American exports to the Orient. As usual, he succeeded, increasing American exports to Japan sevenfold from 1896 to 1905. He continued to reduce his rail rates in order to make American exports profitable. Being an ardent free trader, Hill was a Democrat for most of his life, because the Republican Party since the time of Lincoln had been the main political force behind high protectionist tariffs. (He switched parties late in life when the Democratic Party abandoned its laissez-faire roots and became interventionist, but he considered the Republican Party to be merely the lesser of two evils.)

Recognizing a market in the American Midwest for timber from the Northwest, Hill convinced his next-door neighbor, Frederick Weyerhauser, to get into the timber business with him. He cut his freight charges from ninety to forty cents per hundred pounds, and he and Weyerhauser prospered by selling Northwest timber to other parts of the country.[20]

Despite the quality services and reduced costs that Hill brought to Americans, he would be unfairly lumped in with the political entrepreneurs who were fleecing the taxpayers and consumers. The public eventually began complaining of the monopoly pricing and corruption that were *inherent* features of the government-created and -subsidized railroads.

The federal government responded to the complaints with the Interstate Commerce Act of 1887, which was supposed to ban rail rate discrimination, and later with the Hepburn Act of 1906 which made it illegal to charge different rates to different customers. What these two federal laws did was

to outlaw Hill's price cutting by forcing railroads to charge *everyone* the same high rates.[21] This was all done in the name of consumer protection, giving it an Orwellian aura.

This new round of government regulation benefited the government-subsidized railroads at Hill's expense, for he was the most vigorous price cutter. His trade to the Orient was severely damaged since he could no longer legally offer discounts on exports in order to induce American exporters to join with him in entering as foreign markets. He eventually got out of the steamship business altogether, and as a result untold opportunities to export American products abroad were lost forever.

The Interstate Commerce Commission soon created a bureaucratic monstrosity that attempted to micromanage all aspects of the railroad business, hampering its efficiency even further. This was a classic example of economist Ludwig von Mises's theory of government interventionism: one intervention (such as subsidies for railroads) leads to market distortions which create problems for which the public "demands" solutions. Government responds with even more interventions, usually in the form of more regulation of business activities, which cause even more problems, which lead to more intervention, and on and on. The end result is that free-market capitalism is more and more heavily stifled by regulation.

And on top of that, usually the free market, not government intervention, gets the blame. Thus, all of the railroad men of the late nineteenth century have gone down in history as "robber barons" although this designation definitely does not apply to James J. Hill. It does apply to his subsidized competitors, who deserve all the condemnation that history has provided them. (Also deserving of condemnation are the politicians who subsidized them, enabling their monopoly and corruption.)

Oily Characters?

Another prime example of a market entrepreneur whom generations of writers and historians have inaccurately portrayed — indeed, demonized — is John D. Rockefeller. Like James J. Hill, Rockefeller came from very modest beginnings; his father was a peddler who barely made ends meet. Born in 1839, he was one of six children, and his first job on graduating from high school at age sixteen was as an assistant bookkeeper for fifteen cents a day (under ten dollars a day today, even accounting for nearly 150 years of inflation).[22]

Rockefeller was religious about working and saving his money. After working several sales jobs by age twenty-three he had saved up enough to invest four thousand dollars in an oil refinery in Cleveland, Ohio, with a business partner and fellow church member, Samuel Andrews.[23]

Like James J. Hill, Rockefeller paid meticulous attention to every detail of his business, constantly striving to cut his costs, improve his product, and expand his line of products. He also sometimes joined in with the manual laborers as a means of developing an even more thorough understanding of his business. His business partners and managers emulated him, which drove the company to great success. As economist Dominick Armentano writes, the firm of Rockefeller, Andrews, and Flagler, which would become Standard Oil,

> prospered quickly in the intensely competitive industry due to the economic excellence of its entire operations. Instead of buying oil from jobbers, they made the jobbers' profit by sending their own purchasing men into the oil region. They also made their own sulfuric acid, barrels, lumber, wagons, and glue. They kept minute and accurate records of every item from rivets to barrel bungs. They built elaborate storage facilities near their refineries. Rockefeller bargained as shrewdly for crude as anyone has before or since; and Sam Andrews coaxed more kerosene from a barrel of crude than the competition could. In addition, the Rockefeller firm put out the cleanest burning kerosene and

> managed to profitably dispose of most of the residues, in the form of lubricating oil, paraffin wax, and Vaseline.[24]

Rockefeller pioneered the practice known as "vertical integration," or in-house provision of various inputs into the production process; that is, he made his own barrels, wagons, and so on. This is not always advantageous — sometimes it pays to purchase certain items from specialists who can produce those items at very low cost. But vertical integration has the advantage of allowing one to monitor the quality of one 's own inputs. It has the further advantage of avoiding what modern economists call the "hold-up problem." If, say, an electric power plant contracted with a nearby coal mine for coal to fuel its generating plant, the coal mine might effectively break its contract at one point by demanding more money for its coal. In such instances the power plant has the choice of paying up, engaging in costly litigation, or going without the coal and closing down. None of these options is attractive. But if the power plant simply buys the coal mine, all of these problems disappear. That is what Rockefeller, the compulsive micromanager, did with many aspects of the oil-refining business. He reduced his costs and avoided hold-up problems through vertical integration.

Rockefeller also devised means of eliminating much of the incredible waste that had plagued the oil industry. His chemists figured out how to produce such oil byproducts as lubricating oil, gasoline, paraffin wax, Vaseline, paint, varnish, and about three hundred other substances. In each instance he profited by eliminating waste.

Just as James J. Hill spent the extra money to build the highest quality railroad lines possible, Rockefeller did not skimp in building his refineries. So confident was he of the safety of his operations that he did not even purchase insurance.

Rockefeller also made the oil-refining industry much more efficient. There had been vast overinvestment in the oil industry in its first decades, as everyone had wanted to get rich quick in the business. Northwestern Pennsylvania, where the first oil well had been drilled, was littered with oil derricks and refineries of all sizes, many of which were operated by men who really should have been in another line of work.

Rockefeller purchased many of these poorly managed operations and put their assets to far better use. There was never any threat that these "horizontal mergers" — the combination of two firms that are in the same business — would create a monopoly, for Standard Oil had literally hundreds of competitors, including such oil giants as Sun Oil, not to mention its many large competitors in international markets.

One of Rockefeller's harshest critics was journalist Ida Tarbell, whose brother was the treasurer of the Pure Oil Company, which could not compete with Standard Oil's low prices. She published a series of hypercritical articles in *McClure's* magazine in 1902 and 1903, which were turned into a book entitled *The History of the Standard Oil Company,* a classic of antibusiness propaganda.[25]

Tarbell's writings are emotional, often illogical, and lacking in any serious attempt at economic analysis. But even she was compelled to praise what she called the "marvelous" economy of the entire Standard Oil operation. In a passage describing one aspect of Standard Oil's vertical integration she wrote:

> Not far away from the canning works, on Newtown Creek, is an oil refinery. This oil runs to the canning works, and, as the newmade cans come down by a chute from the works above, where they have just been finished, they are filled, twelve at a time, with the oil made a few miles away. The filling apparatus is admirable As the newmade cans come down the chute they are distributed, twelve in a row, along one side of a turn-table. The turn-table is revolved, and the cans come directly under twelve measures, each holding five gallons of oil — a turn of a valve, and the cans are full. The table is turned a quarter, and while twelve more cans are filled and twelve fresh ones are distributed, four men

> with soldering cappers put the caps on the first set…. The cans are placed at once in wooden boxes standing ready, and, after a twenty-four-hour wait for discovering leaks are nailed up and carted to a nearby door. This door opens on the river, and there at anchor by the side of the factory is a vessel chartered for South America or China … waiting to receive the cans…. *It is a marvelous example of economy, not only in materials, but in time and footsteps* [emphasis added].[26]

Because of Standard Oil's superior efficiency (and lower prices), the company's share of the refined petroleum market rose from 4 percent in 1870 to 25 percent in 1874 and to about 85 percent in 1880.[27]

As Standard Oil garnered more and more business, it became even more efficient through "economies of scale" — the tendency of per-unit costs to decline as the volume of output increases. This is typical of industries in which there is a large initial "fixed cost" — such as the expense involved in building an oil refinery. Once the refinery is built, the costs of maintaining the refinery are more or less fixed, so as more and more customers are added, the cost per customer declines. As a result, the company cut its cost of refining a gallon of oil from 3 cents in 1869 to less than half a cent by 1885. Significantly, Rockefeller passed these savings along to the consumer, as the price of refined oil plummeted from more than 30 cents per gallon in 1869 to 10 cents in 1874 and 8 cents in 1885.[28]

Because he could refine kerosene far more cheaply than anyone else could, which was reflected in his low prices, the railroads offered Rockefeller special low prices, or volume discounts. This is a common, ordinary business practice — offering volume discounts to one's largest customers in order to keep them — but Rockefeller's less efficient competitors complained bitterly. Nothing was stopping them from cutting their costs and prices and winning similar railroad rebates other than their own inabilities or laziness, but they apparently decided that it was easier to complain about Rockefeller's "unfair advantage" instead.

Cornelius Vanderbilt publicly offered railroad rebates to any oil refiner who could give him the same volume of business that Rockefeller did, but since no one was as efficient as Rockefeller, no one could take him up on his offer.[29]

All of Rockefeller's savings benefited the consumer, as his low prices made kerosene readily available to Americans. Indeed, in the 1870s kerosene replaced whale oil as the primary source of fuel for light in America. It might seem trivial today, but this revolutionized the American way of life; as Burton Folsom writes, "Working and reading became after-dark activities new to most Americans in the 1870s."[30] In addition, by stimulating the demand for kerosene and other products, Rockefeller also created thousands upon thousands of new jobs in the oil and related industries.

Rockefeller was extremely generous with his employees, usually paying them significantly more than the competition did. Consequently, he was rarely slowed down by strikes or labor disputes. He also believed in rewarding his most innovative managers with bonuses and paid time off if they came up with good ideas for productivity improvements, a simple lesson that many modern corporations seem never to have learned.

Of course, in every industry the less efficient competitors can be expected to snipe at their superior rivals, and in many instances sniping turns into an organized *political* crusade to get the government to enact laws or regulations that harm the superior competitor. Economists call this process "rent seeking"; in the language of economics, "rent" means a financial return on an investment or activity in excess of what the activity would normally bring in a competitive market. This sort of political crusade by less successful rivals is precisely what crippled the great Rockefeller organization.

The governmental vehicle that was chosen to cripple Standard Oil was antitrust regulation. Standard Oil's competitors succeeded in getting the federal government to bring an antitrust or antimonopoly

suit against the company in 1906, after they had persuaded a number of states to file similar suits in the previous two or three years.

The ostensible purpose of antitrust regulation is to protect consumers, so on the face of it the government's case against Standard Oil seems ludicrous. Because of Standard Oil's tremendous efficiencies, the price of refined petroleum had been plummeting for several decades, generating great benefits for consumers and forcing all other competitors to find ways to cut *their* costs and prices in order to survive. Product quality had improved, innovation was encouraged by the fierce competition, production had expanded dramatically, and there were hundreds of competitors. None of these facts constitutes in any way a sign of monopoly.

As happens in so many federal antitrust lawsuits, a number of novel theories were invented to rationalize the lawsuit. One of them was so-called predatory pricing. According to this theory, a "predatory firm" that possesses a "war chest" of profits will cut its prices so low as to drive all competitors from the market. Then, when it faces no competition, it will charge monopolistic prices.

It is *assumed* that at that point no other competition will emerge, despite the large profits being made in the industry. Journalist Ida Tarbell did as much as anyone to popularize this theory in her book on Standard Oil, in a chapter entitled "Cutting to Kill." To economists, however, predatory pricing is theoretical nonsense and has no empirical validity, either. It has never been demonstrated that a monopoly has ever been created in this way. Certainly predatory pricing was not a tactic used by Standard Oil, which was never a monopoly anyway.

In a now-classic article on the topic in the prestigious *Journal of Law and Economics,* John S. McGee studied the Standard Oil antitrust case and concluded not only that the company did not practice predatory pricing but also that it would have been irrational and foolish to have attempted such a scheme.[31] And whatever else may be said about John D. Rockefeller, he was no one's fool.

McGee was quite right about the irrationality of predatory pricing. As an investment strategy, predatory pricing is all cost and risk and no potential reward. The would-be "predator" stands to lose the most from pricing below its average cost, since, presumably, it already does the most business. If the company is the market leader with the highest sales and is losing money on each sale, then that company will be the biggest loser in the industry.

There is also great uncertainty about how long such a tactic could take: ten years? twenty years? No business would intentionally lose money on every sale for years on end with the pie-in-the-sky hope of someday becoming a monopoly. Besides, even if that were to occur, nothing would stop new competitors from all over the world from entering the industry and driving the price back down, thereby eliminating any benefits of the predatory pricing strategy.

Finally, there is a logical contradiction in the theory. The theory assumes a "war chest" of profits that is used to subsidize the money-losing strategy of predatory pricing. But where did this war chest come from? The theory posits that predatory pricing is what creates a war chest of "monopoly profits," but at the same time it simply assumes that these profits already exist!

After examining some eleven thousand pages of the Standard Oil case's trial record, McGee concluded that there was no evidence at all presented at trial that Standard Oil had even attempted to practice predatory pricing. What it did practice was good old competitive price cutting, driven by its quest for efficiency and customer service.

The antitrust case against Standard Oil also seems absurd because its share of the petroleum products market had actually dropped significantly over the years. From a high of 88 percent in 1890, Standard Oil's market share had fallen to 64 percent by 1911, the year in which the US Supreme Court reaffirmed the lower court finding that Standard Oil was guilty of monopolizing the petroleum products industry.[32]

The court argued, in essence, that Standard Oil was a "large" company with many divisions, and if those divisions were in reality separate companies, there would be more competition. The court made no mention at all of the industry's economic performance; of supposed predatory pricing; of whether industry output had been restrained, as monopoly theory holds; or of any other economic factors relevant to determining harm to consumers. The mere fact that Standard Oil had organized some thirty separate divisions under one consolidated management structure (a trust) was sufficient reason to label it a monopoly and force the company to break up into a number of smaller units.

In other words, the organizational structure that was responsible for the company's great efficiencies and decades-long price cutting and product improving was seriously damaged. Standard Oil became much *less* efficient as a result, to the benefit of its less efficient rivals and to the detriment of consumers. Standard Oil's competitors, who with their behind-the-scenes lobbying were the main instigators of the federal prosecution, are (along with "muckraking" journalists like Ida Tarbell) the real villains in this story. They succeeded in using political entrepreneurship to hamstring a superior market entrepreneur, which in the end rendered the American petroleum industry *less* competitive.

The prosecution of Standard Oil was a watershed event for the American petroleum industry. It emboldened many in the industry to pay less and less attention to market entrepreneurship (capitalism) and more to political entrepreneurship (mercantilism) to profit.

During World War I the oil industry became "partners" with the federal government ostensibly to assure the flow of oil for the war effort. (Of course, in such arrangements the government is always the "senior partner.") As Dominick Armentano writes:

> The Oil Division of the U.S. Fuel Administration in cooperation with the War Services Committee, was responsible for determining oil production and for allocating crude supplies among various refiners. In short, these governmental organizations, with the coordinating services of leading business interests, had the legal power to operate the oil industry as a cartel, eliminating what was described as "unnecessary waste" (competition), and making centralized pricing and allocative decisions for the industry [i.e., price fixing] as a whole. Thus, the wartime experiment in "planning" (i.e., planning by political agents to satisfy political interests rather than by consumers, investors, and entrepreneurs to meet consumer demand) created what had previously been unobtainable: a government sanctioned cartel in oil.[33]

After the war, oil industry executives favored extending this government-sanctioned and -supervised cartel. President Calvin Coolidge created a Federal Oil Conservation Board that enforced the "compulsory withholding of oil resources and state prorationing of oil," a convoluted way of saying "monopoly."[34]

The newly formed American Petroleum Institute, an industry trade association, lobbied for various regulatory schemes to restrict competition and prop up prices; it did not even pretend to be in favor of capitalism or free enterprise. The institute even endorsed the use of National Guard troops to enforce state government production quotas in Texas and Oklahoma in the early l930s.

During the 1930s even more teeth were put into government oil industry cartel schemes. The National Recovery Act empowered the federal government to support state oil production quotas to assure output reductions and higher prices. Interstate and foreign shipments of oil were strictly regulated so as to create regional monopolies, and import duties on foreign oil were raised to protect the higher-priced American oil from foreign competition.[35]

In 1935 Congress passed the Connally Hot Oil Act, which made it illegal to transport oil across state lines "in violation of state proration requirements."[36] In the l950s the government placed import quotas on oil, creating an even greater monopoly power. All of this, you will recall, came on the heels of the government's antitrust crusade against the Standard Oil "monopoly." Clearly, the

purpose of the political persecution of Standard Oil had been to begin stamping out competition in the oil industry. That process was continued with a vengeance with forty years of squalid political entrepreneurship. By the middle of the twentieth century, real capitalism had all but disappeared from the oil industry.

Vanderbilt Takes on the Monopolists

The battle between market and political entrepreneurs was not confined to the railroad and oil industries. Indeed, from the mid-nineteenth century onward, this sort of battle marked the development of much of American industry — the steamship industry, the steel industry, and the auto industry, to name just a few.

For example, the great steamship entrepreneur Cornelius Vanderbilt competed with government-subsidized political entrepreneurs for much of his career. In fact, he got his start in business by competing — illegally — against a state-sanctioned steamship monopoly operated by Robert Fulton. In 1807, the New York state legislature had granted Fulton a legal, thirty-year monopoly on steamboat traffic in New York — a classic example of mercantilism.[37] In 1817, however, a young Cornelius Vanderbilt was hired by New Jersey businessman Thomas Gibbons to defy the monopoly and run steamboats in New York. Vanderbilt worked in direct competition with Fulton, charging lower rates as his boats raced from Elizabeth, New Jersey, to New York City; to underscore the challenge to Fulton's monopoly, Vanderbilt flew a flag on his boats that read NEW JERSEY MUST BE FREE. Slowly he was breaking down the Fulton monopoly, which the US Supreme Court finally ended in 1824, ruling in *Gibbons* v. *Ogden* that only the federal government, not the states, could regulate interstate trade under the Commerce Clause of the Constitution.[38]

As the cost of steamboat traffic plummeted because of deregulation, the volume of traffic increased significantly and the industry took off. Vanderbilt became the leading market entrepreneur in the industry, but he would continue to face government-subsidized competitors. For example, steamship operator Edward K. Collins convinced Congress that it needed to subsidize the transatlantic steamship business to compete with the Europeans and to create a military fleet in case of war. In 1847 Congress awarded Collins $3 million, plus $385,000 per year. Sitting on these fat subsidies, Collins had little incentive to build his ships efficiently or to watch his costs once they were built. Instead of focusing on making his business more efficient, Collins spent lavishly on lobbying, including wining and dining President Millard Fillmore, his entire cabinet, and many congressmen.[39]

Like James J. Hill in the railroad industry, Vanderbilt did not shy away from competing against his heavily subsidized rivals. Not surprisingly, these government-supported rivals ultimately could not keep up with Vanderbilt, in large part because the stifling regulations that were inevitably attached to the government subsidies made these steamship lines remarkably inefficient. By 1858, Collins's line had become so inefficient that Congress ended his subsidy, and he promptly went bankrupt. He could not compete with Vanderbilt on an equal basis.

The Real History

The lesson here is that most historians are hopelessly confused about the rise of capitalism in America. They usually fail to adequately appreciate the entrepreneurial genius of men like James J. Hill, John D. Rockefeller, and Cornelius Vanderbilt, and more often than not they lump these men (and other market entrepreneurs) in with genuine "robber barons" or political entrepreneurs.

Most historians also uncritically repeat the claim that government subsidies were necessary to building America's transcontinental railroad industry, steamship industry, steel industry, and other industries. But while clinging to this "market failure" argument, they ignore (or at least are unaware of) the fact that market entrepreneurs performed quite well without government subsidies. They also ignore the fact that the subsidies themselves were a great source of inefficiency and business

failure, even though they enriched the direct recipients of the subsidies and advanced the political careers of those who dished them out.

Political entrepreneurs and their governmental patrons are the real villains of American business history and should be portrayed as such. They are the real robber barons.

At the same time, the market entrepreneurs who practiced genuine capitalism, whose genius and energy fueled extraordinary economic achievement and also brought tremendous benefits to Americans, should be recognized for their achievements rather than demonized, as they so often are. Men like James J. Hill, John D. Rockefeller, and Cornelius Vanderbilt were heroes who improved the lives of millions of consumers; employed thousands and enabled them to support their families and educate their children; created entire cities because of the success of their enterprises (for example, Scranton, Pennsylvania); pioneered efficient management techniques that are still employed today; and donated hundreds of millions of dollars to charities and nonprofit organizations of all kinds, from libraries to hospitals to symphonies, public parks, and zoos. It is absolutely perverse that historians usually look at these men as crooks or cheaters while praising and advocating "business/government partnerships," which can only lead to corruption and economic decline.

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2. Albro Martin, *James J. Hill and the Opening of the Northwest* (New York: Oxford University Press, 1976), 411.
3. Ibid., 4l0.
4. Albro Martin's *James J. Hill and the Opening of the Northwest* is an excellent biography of Hill, as is Michael P. Malone's *James J. Hill: Empire Builder of the Northwest* (Norman: University of Oklahoma Press, 1996). Hill also wrote an autobiography, *Highways of Progress* (New York: Doubleday, 1910).
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6. Ibid., 37.
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8. Ibid., 53
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10. Ibid., 90.
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30. Folsom, *Entrepreneurs vs. the State,* 87.
31. John S. McGee, "Predatory Price Cutting: The Standard Oil (N.J.) Case," *Journal of Law and Economics* 1 (October 1958): 144 — 58.
32. See Armentano, *Antitrust and Monopoly,* 68 — 73.
33. Ibid., 74.
34. Ibid., 75.
35. Ibid.

36. Ibid., 76.
37. Folsom, *Entrepreneurs vs. the State,* 2.
38. Ibid.
39. Ibid., 7.

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